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C O N F I D E N T I A L SECTION 01 OF 03 HONG KONG 001104

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STATE FOR EAP/CM AND EEB/IFD/OMA, TREASURY FOR OASIA

E.O. 12958: DECL: 06/12/2034
TAGS: EFIN ECON HK CH
SUBJECT: HONG KONG'S SLOW ROAD TO RMB INTERNATIONALIZATION

Classified By: Acting Consul General Christopher Marut, Reason 1.4 b

¶1. (C) Summary and Comment: With the Hong Kong economy shrinking as a result of reduced financial and trade flows, local policymakers are looking to the Mainland for approval for expanded Renminbi (RMB) use in Hong Kong. Mainland authorities appear to be moving slowly to permit additional RMB transactions in Hong Kong by approving Hong Kong banks to issue RMB bonds and floating the prospect of permitting selected Hong Kong and Mainland enterprises to settle trade accounts in RMB. These are small steps that are unlikely to affect Hong Kong's short-term economic situation, but supporters say they could have far-reaching effects on the use of the RMB outside of China, potentially even paving the way for the eventual transition to free convertibility of the RMB. While the Hong Kong government and many local policy analysts applaud these measures, no one is expecting a flood of RMB business in Hong Kong any time soon. The obstacles to a meaningful increase in Hong Kong RMB transactions are still significant. A limited supply of RMB deposits in Hong Kong, relatively easy and inexpensive access to RMB for most large companies in the Mainland, recent RMB stability against the U.S. dollar and a meager product-range for participating banks will all limit the practical usefulness of these measures for Hong Kong-based companies. The symbolic approval of additional channels for RMB transactions should be welcomed, but meaningful RMB use in Hong Kong requires expanding the pool of locally available deposits and allowing Hong Kong to take advantage of its sophisticated and well-regulated financial sector. Permitting local bans to issue RMB-denominated loans would greatly exand the amount of available RMB funds and encourge Hong Kong-based companies to keep their RMB bsiness in Hong Kong. End Summary and Comment.

Chines Measures to Expand RMB Use in HK

¶2. (SBU) In December 2008, the Chinese authoriies announced plans to liberalize RMB bond issuane in Hong Kong and in April 2009 announced that pproved enterprises, beginning with a selected goup in Hong Kong, will be allowed to settl trade transactions with Mainland counterparts in RMB. Five Chinese banks have been approved to issue RMB-denominated bonds in Hong Kong since July 2007, although the amounts have been relatively small, with just RMB 22 billion (US$3.2 b) issued since that time. Hong Kong Shanghai Banking Corp. (HSBC) and Bank of East Asia (BEA) announced May 19 that they had received approval from the State Administration for Foreign Exchange (SAFE) to issue RMB bonds in Hong Kong, the first non-Mainland banks to do so. While the details of these bond offerings have not been announced, observers speculate that RMB raised in Hong Kong will allow these banks to more easily meet capital requirements for their Mainland branches and reduce their reliance on interbank borrowing in China. Hong Kong authorities say they are optimistic that local non-bank entities, including manufacturers, real estate

developers, or others, may also be permitted to issue RMB-denominated bonds in Hong Kong in the near future.

¶3. (C) The Hong Kong government enthusiastically supported the Chinese government's two announcements expanding the scope of RMB use in Hong Kong. Secretary for Financial Services and the Treasury K.C. Chan acknowledged that allowing banks and other corporate entities to issue RMB bonds in Hong Kong is only a small step. But he believes that expanding the range of businesses able to raise RMB outside of China will encourage additional RMB liberalization, with Hong Kong as a primary beneficiary.

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RMB Bonds May Not Hit HR in HK
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¶4. (C) Approval for Hong Kong banks and corporates to issue RMB bonds in Hong Kong has the potential to promote additional use of the RMB here, but some private sector analysts are skeptical of the practical near-term value of the measures. Bank of China International Managing Director Anthony Lok believes the prospect of issuing RMB bonds is not attractive to most Hong Kong businesses. With the current cost of capital in China extremely low, large companies generally have little difficulty borrowing from Mainland banks. RMB bonds in Hong Kong will be too expensive and include relatively high administration costs. In addition, Hong Kong borrowers are already accustomed to using established currency exchange mechanisms, and may be reluctant to test new RMB bonds, said Lok. Finally, with

only about RMB 53 billion (US$7.7 b) in the Hong Kong banking system as of Q1 2009, the pool of RMB funds is too small to create a meaningful bond market.

¶5. (C) Azure Tax Managing Director Deborah Annells agreed and noted that Hong Kong's tax system promotes equities and discourages bond sales in the city by taxing bond interest, while exempting dividends. It is also not clear that mechanisms currently exist for non-banks to remit RMB to pay off bond holders at maturity. Terry Ng, Executive Director at Hong Kong property developer Hang Lung, said Hong Kong-based RMB bonds are not attractive for Hong Kong real estate companies. Although most have large projects in China, the large Hong Kong-based real estate developers are able to secure RMB bank funding in China and have had no problems converting foreign exchange for local investments. However, for small and medium enterprises (SMEs) in Hong Kong with operations in the Mainland and limited access to RMB bank financing, the ability to issue small tranches of RMB bonds might be attractive. What remains unclear is why these potential issuers might prefer to do so in Hong Kong rather than in the more liquid markets of Shanghai or Shenzhen.

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Waiting for the Pilot RMB Trade Settlement Scheme
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¶6. (SBU) In April 2009, the PRC State Council announced that eligible enterprises in selected Chinese cities (Shanghai, Shenzhen, Guangzhou, Zhuhai and Dongguan) will soon be allowed to settle trade accounts in RMB with selected partners in Hong Kong, Macau and ASEAN countries. Under this pilot scheme, Hong Kong enterprises will be allowed to quote and settle their Hong Kong-Mainland trade in RMB instead of US dollars, potentially reducing settlement costs and shifting exchange rate risk away from Mainland enterprises. Supporters of the trade settlement scheme note that Hong Kong companies with large export-oriented operations in Guangdong saw their export competitiveness suffer as the RMB appreciated against the US dollar over the past several years and could benefit from an enhanced ability to manage exchange rate risk. Hong Kong banks will have the opportunity to expand their range of RMB business, which is currently

limited to deposits, remittances, exchange services, checking accounts, and credit cards for Hong Kong residents.

¶7. (SBU) Hong Kong government officials believe the pilot scheme will work as follows: Eligible enterprises in Hong Kong will be allowed to open corporate RMB bank accounts with selected Hong Kong banks for the purposes of trade settlement with eligible Mainland enterprises and to deposit RMB into those accounts. They will then be allowed to transfer RMB to approved correspondent accounts for trade-related transactions. Currently, individuals can hold RMB deposit accounts in Hong Kong banks, but they cannot directly transfer RMB into or out of China and are subject to low daily limits on the amount of RMB that can be purchased or sold.

¶8. (C) Although the State Council decision was announced more than two months ago, additional details have been slow to emerge. Hong Kong-based analysts believe the pilot has been delayed due to the inability of Chinese Customs authorities to mesh their export-rebate protocols, which are tied to foreign currency transactions, with RMB denominated transactions. Hong Kong University professor Frank Song sees this pilot program as an important step towards internationalization of the RMB and for Hong Kong,s aspirations to become an offshore RMB center. Goldman Sachs Executive Director Enoch Fung added that cross-border trade settlement in RMB will increase the circulation of RMB in the Hong Kong economy and could eventually lead to a dual currency system in Hong Kong.

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RMB Trade Settlement May Not Meet HK Needs
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¶9. (C) While another positive step towards loosening restrictions on the international use of the RMB, the successful implementation of the trade settlement scheme faces a number of obstacles. First, while conducting trade settlement in RMB will help Mainland-based exporters better manage their currency risk, the stable U.S. dollar/RMB exchange rate over the past six months reduces the immediate need for exporters to seek to avoid U.S. dollar exposure. In addition, denominating transactions in RMB simply pushes currency risk to importers. With markets for Chinese exports still weak, importers may not be willing to assume that

additional risk.

¶10. (C) In addition, with over US$350 billion in annual trade between Hong Kong and the Chinese mainland, the supply of RMB in Hong Kong is currently far too low to support a significant expansion of RMB transactions. While the Hong Kong Monetary Authority and the PBOC did enter into a RMB 200 billion (US$29 b) currency swap arrangement early in 2009, it is not clear that those funds would be available to support additional trade settlement requirements.

¶11. (C) Finally, the value of this new scheme to Hong Kong banks looks to be minimal, at least initially. It appears that the pilot scheme will be confined to the very basic forms of trade settlement, with RMB transactions confined to exchanges and transfers between corporate RMB account holders. The more lucrative, and for banks more interesting, ability to issue RMB denominated trade financing does not seem to be included. If Hong Kong banks are allowed to issue RMB-denominated credit, it will make the prospect of RMB trade settlement business more appealing for them and through the multiplier effect increase the amount of RMB available in Hong Kong.
MARUT